SEVEN WAYS TO LEAVE YOUR CREDITORS

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I. INTRODUCTION

A. At some point in your practice you will encounter a client who is having financial difficulties and has trouble servicing its debt. While it may not be a serious or long term problem in all cases, depending upon the number and aggressiveness of its creditors, and the severity of the client's financial distress, resolving creditor issues may require the assistance of insolvency professionals and the implementation of a mechanism that will allow the debtor to address creditor claims in an orderly and fair manner.

B. The purpose of this presentation is to provide a bird's-eye view of the various remedies that are available to a client that is in a precarious position with its creditors. Filing a bankruptcy petition is the remedy that immediately comes to mind, but there are other alternatives, and depending on your client's circumstances and objectives, its interests may be better served by certain remedies rather than others. Therefore, in addition to the bankruptcy court, we will address State and Federal Court Receiverships, Assignments for the Benefit of Creditors, Trust Mortgages, Voluntary Surrender and Uniform Commercial Code Article 9 Sales and Fiduciary Alternatives, as well as the option of simply retaining control without oversight from a third party.

II. BANKRUPTCY

A. The Bankruptcy Estate: A bankruptcy case is commenced by electronically filing the bankruptcy petition paperwork with the Bankruptcy Court. The commencement of a bankruptcy case creates an "estate." The estate becomes the temporary legal owner of all of the debtor's assets and property rights, with a few exceptions. Assets that are part of the

estate are subject to the exclusive control and protection of the bankruptcy court, unless and until those assets are removed from the estate. The definition of what constitutes property of the bankruptcy estate is very broad and includes almost every imaginable kind of property that the debtor owns at the time the bankruptcy case is filed. It includes:

1. All of the debtor's interests in tangible property (such as personal property, real estate, vehicles, financial accounts, etc.);

2. The debtor's property that is in someone else's possession (such as a security deposit, items in storage, or property that the debtor has loaned to someone else);

3. In individual debtor cases, certain interests in community property with a spouse (when community property rules apply);

4. Funds that the debtor is entitled to receive, but does not have yet (such as wages, commissions, tax refunds, accounts receivable and other refunds);

5. Intangible assets (such as the right to file a lawsuit);

6. Certain property acquired within 180 days after filing for bankruptcy (such as an inheritance, property from a divorce settlement or judgment, or life insurance policy proceeds);

7. Revenue generated from other property of the estate (such as rental income from rental real estate);

8. Appreciation in value of assets of the estate;

9. Property that the debtor has fraudulently transferred prior to the bankruptcy (such as assets transferred for substantially less than fair market value);

10. Certain payments the debtor has made to creditors prior to the bankruptcy.

B. <u>The Automatic Stay</u>: Upon the filing of a bankruptcy petition, Section 362 of the United States Bankruptcy Code imposes an automatic injunction that halts almost any action by creditors (including foreclosure proceedings, evictions, garnishments, lawsuits, repossessions), with certain exceptions, that attempt to collect a debt that arose prior to the petition date. The Automatic Stay is the primary motivation for filing a bankruptcy petition, as it prevents the "race to the courthouse" by creditors seeking to get what they can.

1. Creditors can apply to a Bankruptcy Court to modify, for cause, the Automatic Stay, in order to take action that may otherwise be enjoined. Creditors with a security interest in property of the debtor are the typical parties that request modification of the Stay in order to foreclose on their security interests when the debtor cannot continue to make payments and there isn't enough equity in the property to cover the loan. A court might deny the motion if the debtor shows that there is an "equity cushion" or that the creditor is "adequately protected" from financial loss, for instance if the value of the secured creditor's collateral will not decline during the bankruptcy proceedings despite being under-collateralized. Unsecured creditors typically don't have a basis to request that the stay be lifted.

2. The Automatic Stay only enjoins actions against property of the Bankruptcy Estate. Therefore, the Automatic Stay does not enjoin action against other parties who are also liable for the debts of the debtor. For example, actions against a guarantor or an insurer are not usually stayed.

C. Distribution of Assets: The Priority Scheme set forth by the Bankruptcy Code dictates the order in which claims are paid. It is essentially a multi-tiered waterfall. The most senior class of creditors must get paid in full before creditors in the next pool down can get paid, and so on, until a class of creditors for which there are insufficient assets to pay their claims in full is reached. The class of creditors that do not get paid in full usually receive a *pro-rata* distribution on their claims.

1. Secured creditors: Creditors who have valid and perfected security interests are paid in full from the proceeds of the secured asset to the extent of the value of the asset. For example if a secured creditor has a claim of $100.00 and the asset is worth $500.00, the creditor is paid the full $100.00. The remaining value of the asset is property of the Estate and can be used to satisfy the claims of other creditors. On the other hand, if the asset is worth only $50.00, the creditor gets paid the full $50.00, and will have an unsecured claim for the remaining $50.00.

2. Priority Scheme for Unsecured Creditors: Unsecured creditors may be entitled to administrative or priority claims. The priorities among unsecured creditors are set forth in Section 507 of the Bankruptcy Code.

   a. Administrative Claims: Section 507(a)(1) gives a first priority to domestic support obligations. However, Section 507(a)(2) gives the second priority to the more generally applicable "administrative expenses allowed under §503(b)." Section 503(b)(1)(A) in its turn defines "administrative expenses" as "the actual, necessary costs and expenses of preserving the estate." In a Chapter 11 case, administrative claims include post-petition rent, post-petition account trade payables, post-petition wages, salaries, and commissions due to employees

of a debtor, as well as the fees of the professionals who are administering the bankruptcy estate or representing the debtor. As stated, these are typically expenses that arise after the bankruptcy petition is filed, but the value of any goods received by the debtor within 20 days before the petition date also qualifies as an administrative expense claim under Section 503.

b. Pre-Petition Priority Claims: In addition to administrative claims under 507(a)(2), there are a number of other provisions which grant priority status to other types of claims that arise prior to the petition date. Most of them are of special interest and have little to do with the ordinary case. However, two are worth pointing out, as they occur much more frequently.

   i. Taxes: Section 507(a)(8) grants a priority claim to certain taxes incurred pre-petition to the extent they are unsecured. In many cases, tax claims will be secured by liens, and that will lead to a possible bifurcated claim as discussed with respect to other types of secured creditors set forth above.

   ii. Employee Wages and Benefits: Sections 507(a)(4) and (a)(5) grant priority status to the unsecured claims of employees of the debtor for wages, salaries and commissions (507(a)(4)) and contributions to employee benefit plans (507(a)(5)), earned within 180 days of the petition dates.

c. Finally, as mentioned earlier, to the extent that a claim is not secured, or does not qualify as a administrative or priority claim, it is categorized as a general unsecured claim.

d. In a Chapter 11 case, all administrative and priority claims must be paid in full for a Chapter 11 plan to be confirmed. Because it is highly unlikely that there will be sufficient assets to pay all claims in full, in a Chapter 11 case general unsecured claims will share pro-rata in whatever assets of the estate remain after paying the secured, administrative, and priority claims. This rule does not apply in a Chapter 7 case. Rather administrative and priority claims are paid according to where they fall on the priority waterfall, but to what extent they are paid in full will depend on the assets available to distribute.

e. There are exceptions to every rule some of which are: in a chapter 11 case, the court may confirm a reorganization plan that (within limits) can vary the rules of distribution set forth so far. Second, the Bankruptcy Code also provides that the judge may, in an appropriate case, "subordinate" one claim to another (See Section 510). Likewise, case law permits the court (under limited circumstances) to "re-characterize" debt as equity— which also has an impact on the priority scheme.

D. Chapter 7 and Chapter 11 Bankruptcy Proceedings: There are five different types of bankruptcy outlined by the United States Bankruptcy Code. Each type of bankruptcy is identified by the chapter of the Code that governs it. Chapter 9 Bankruptcy concerns the bankruptcy filings of a municipality or government entity. Chapter 12 Bankruptcy concerns bankruptcy filings of commercial farmers and fisherman. Chapter 13 Bankruptcy is only available to individuals and involves the debtor paying its creditors over a three to five year period pursuant to a Chapter 13 plan.

1. <u>Chapter 11 Bankruptcy</u>: A Chapter 11 bankruptcy proceeding is frequently referred to as a reorganization with the idea that the

bankruptcy proceeding allows the debtor to restructure its finances and maximize the return to its creditors and owners.

a. The Debtor Continues with Business Operations: In most cases, a third-party bankruptcy trustee is not appointed over a Chapter 11 bankruptcy estate. Rather, the debtor continues to operate its business in the ordinary course as the "debtor in possession" (or "DIP"). The bankruptcy court can appoint a trustee to take over operations from the debtor if it finds sufficient cause. Cause for appointing a trustee includes fraud, dishonesty, incompetence, and gross mismanagement of the debtor's affairs.

b. The Bankruptcy Court is Ultimately In Control of Major Decisions: While the debtor ordinarily continues in business after it files Chapter 11, it loses control over major decisions, which the bankruptcy court must approve after notice and input is received from the debtor's creditors. Among other things, the bankruptcy court must approve:

1. Any sale of assets, such as property or real property (except for items such as inventory sold by a retail debtor in the ordinary course of business);

2. Entering into or breaking a lease of real or personal property;

3. Mortgage or other secured financing arrangements that allow the debtor to borrow money after the case is filed

4. Shutting down or expanding business operations;

5. Entering into or modifying union, vendor, licensing, and other contracts and agreements; and

6. The retention of, and payment of fees and expenses to, attorneys and other professionals.

c. The Role of Creditors: Creditors, shareholders, and other parties in interest may support or oppose actions that require bankruptcy court approval. The bankruptcy court will consider input from creditors and other parties in deciding how to proceed. Formal votes by creditors and equity holders, however, are taken only in connection with proposed Chapter 11 plans. Unsecured creditors usually participate in the Chapter 11 case through a committee that is appointed to represent their interests. The unsecured creditors' committee can retain attorneys and other professionals to assist it at the debtor's expense. In some cases, equity security (i.e., shareholder) and other committees also take an active role.

d. The Chapter 11 Plan: A Chapter 11 plan allows a debtor to reorganize, or in other words, restructure, its financial affairs. A Chapter 11 plan is, in effect, a contract between the debtor and its creditors as to how it will operate and pay its obligations in the future. Most plans provide for at least some downsizing of the debtor's operations to reduce expenses and free up assets. In some cases, "liquidating plans" are proposed to provide for a total shutdown of the debtor's operations and the orderly sale of its remaining property. Very rarely, a Chapter 11 plan will provide for full and immediate payment of all creditors. Generally, however, creditors are entitled to vote on whether they accept a

proposed Chapter 11 plan. At least one class of "impaired" claims must vote in favor of a Chapter plan for it to be approved by the bankruptcy court. An "impaired" claim is an obligation that will not be paid in full upon plan confirmation or when originally due.

e. Chapter 11 Plan Confirmation: Section 1129 of the Bankruptcy Code governs confirmation of the Chapter 11 Plan. It sets forth 16 requirements that must be satisfied. Approval of a proposed plan is referred to as "confirmation." Creditors are entitled to vote on the plan but confirmation of the plan ultimately rests with the bankruptcy court. Confirmation requirements include:

1. Feasibility. The bankruptcy court must find that the proposed plan is feasible, or in other words, likely to succeed. The debtor must prove to the court that it will be able to raise sufficient revenues over the plan term to cover its expenses, including payments to creditors.

2. Good Faith. The court must find that the plan has been proposed in good faith and not by means forbidden under applicable law.

3. Best Interests of Creditors. For a proposed plan to be confirmed, it must be in the best interests of its creditors. In Chapter 11, the "best interests" test requires that creditors receive at least as much under a proposed plan as they would if the debtor's case were converted to a Chapter 7 liquidation. In some cases, the "best interests" test requires the debtor to pay all of its creditors in full. Most Chapter 11 debtors,

however, are financially underwater and can meet the "best interests" test by paying creditors only a fraction of what they owe.

4. Voting: Each class of claims or interests must either have voted to accept the plan, or their claims are not impaired under the plan.

5. Cramdown: Even if an impaired class of claims votes against the plan, the Bankruptcy Code will allow the debtor to cram the chapter 11 plan "down the throats" of that impaired class of claims. In order to do this, all other confirmation requirements under Section 1129(a) must have been met, and at least one class of impaired claims must have voted to accept the plan. If this is the case, Section 1129(b) will allow the court to confirm the plan if it does not discriminate unfairly and is fair and equitable. The Bankruptcy Code defines "fair and equitable" differently for secured and unsecured claims. A plan is typically not considered fair and equitable with respect to a dissenting class of *secured* claims unless the plan provides for the full payment or the realization of the "indubitable equivalent" of the allowed amount of each secured claim. With respect to a dissenting class of *unsecured* claims, a plan is generally not fair and equitable if it violates the absolute priority rule. The gist of the absolute priority rule is that a junior class of creditors may not receive or retain any property on account of its claims unless the claims of a dissenting senior class are satisfied in full.

f. The advantage of a Chapter 11 bankruptcy is that the debtor will continue to operate the business, with court oversight, and if a Chapter 11 Plan is confirmed, will emerge from bankruptcy better able to handle future financial stress. In addition, if the debtor follows through with its obligations under the Chapter 11 Plan, all of the pre-bankruptcy petition debt that the debtor cannot pay will be discharged. The downside of a Chapter 11 bankruptcy proceeding is that it may often be cost-prohibitive in terms of the professional fees and costs that are incurred during the course of the proceeding. It is also true that a fairly low percentage of Chapter 11 cases result in successful reorganizations. More often, a Chapter 11 Plan involves the liquidation of the debtor. In this scenario, the debtor will sell substantially all of its assets free and clear of all liens, claims, and encumbrances under Section 363 of the Bankruptcy Code, with any liens, claims, and encumbrances attaching to the sale proceeds. The buyer of the assets may continue to operate the business, but will be assured that none of the debtor's pre-petition creditors can assert claims against it. After the sale, the debtor will then liquidate whatever assets remain (including various actions to claw-back preference payments, insider transfers, and fraudulent transfers, which is beyond the scope of this presentation) with the proceeds of those assets used to pay the debtor's creditors as provided under the liquidating plan. However, a liquidating Chapter 11 Plan must still pay all administrative and pre-petition priority claims, and if it cannot, it will typically be converted to a Chapter 7 case, and a Chapter Trustee will take over the role of liquidating assets and distributing proceeds to creditors.

2. Chapter 7 Bankruptcy: In some cases, even an attempt at filing a Chapter 11 bankruptcy proceeding is not an option, whether by choice or by financial constraints. In a Chapter 7 bankruptcy proceeding, a Chapter 7 Trustee is appointed to immediately take over the business and liquidate its assets. With some exceptions, the Trustee's rights with respect to the assets are no greater than the debtor's rights. For this reason, it is often said that the Trustee "steps into the shoes" of the debtor. While the Chapter 7 Trustee can continue to operate the business in limited circumstances, it is rare. The benefit of a Chapter 7 bankruptcy proceeding is that it provides for a simple and orderly liquidation of the businesses assets, with the burden of selling assets and paying creditors placed on the trustee instead of the business owners. The Bankruptcy Court still has ultimate control with respect to the Chapter 7 Trustee's actions, and the debtor's creditors still have the opportunity to provide input regarding the same. Of course, when compared to a liquidating Chapter 11 bankruptcy proceeding, the downside of the Chapter 7 is that the business has no control in how the business assets are administered and liquidated, and the presence of a Chapter 7 Trustee may mean increased scrutiny of how the debtor was run and whether any of its principals may have obligations to the bankruptcy estate.

a. The information regarding the Bankruptcy Estate, the Automatic Stay, and the creditor distribution scheme all apply in a Chapter 7 bankruptcy proceeding. The main difference is that there is no requirement that administrative and pre-petition priority claims be paid in full. They are paid according to their priority, but it is often the case that there is not enough money to pay them all in full.

b. It is also important to keep in mind that, particularly in the case of a small business, it may be more important for the business owners individually file a Chapter 7 Bankruptcy rather than the business. This is the case when the owners may also be liable for the

businesses debts, whether through the structure of the business (a sole proprietorship or partnership), because they have guaranteed some of the businesses debt, or by operation of some other law, such as where it is likely that the corporate veil can be pierced, or the nature of the business places personal obligations on business owners, such as individual fiduciary duties.

3. Involuntary Chapter 7 or 11 Bankruptcies: Section 303 of the Bankruptcy Code allows creditors to file an involuntary Chapter 7 or Chapter 11 bankruptcy petition on behalf of the debtor.

   a. The filing of an involuntary bankruptcy petition usually requires a showing of insolvency or a transfer of the debtor's assets to a liquidating agent and three creditors, who each hold claims that are not contingent or subject to a bona fide dispute as to liability or amount, if the three claims aggregate at least $15,775.00.

   b. This remedy is rarely used because most creditors would prefer to pursue the debtor separately and "race to the assets" rather than set up a procedure whereby all creditors share in the liquidation proceeds. There is also a substantial risk of having to pay the debtor's attorneys' fees and other damages if the petition is dismissed.

III. FEDERAL AND STATE COURT RECEIVERSHIPS:

Considering the foregoing concerning Chapter 11 bankruptcy proceedings, their cost, and the fact that they oftentimes result in a liquidation of the debtor's assets in any event, state and federal court receiverships have been on the rise as a viable alternative to the Bankruptcy Court.

A. General Concepts: A receiver is an officer of the court that is appointed to take possession, custody, and control of specified real estate and/or personal property, commonly referred to as the "receivership estate," and

to dispose of that property through its sale, abandonment, or other means. Like a bankruptcy trustee, the receiver steps into the shoes of the owner of the property. Unlike a voluntary bankruptcy proceeding however, a receivership is a creditor remedy in which the creditor, in connection with pending litigation, files a motion with the court requesting that a receiver be appointed over the assets of the defendant's property. The general rule is that a receiver is an officer of the appointing court and is viewed as a fiduciary representing the interests of all parties with interests in the litigation in which the receiver is appointed, including creditors of the defendant. Although it is ultimately the court's decision whether a receiver is necessary and who it should be, it is the applying creditor that requests a particular receiver, and that decision is often based on whether the creditor believes the receiver will act in the creditor's interest.

1. There are a number of situations in which a receivership is warranted or beneficial. These include the dissolution of a corporation, where there is a dispute among shareholders, or in pursuit of a judgment, when a receiver would be appointed to control the assets of the judgment debtor. However, the most common circumstance is when a secured creditor seeks to foreclose on property and requests that a receiver be appointed to take possession of the secured property, operate it, and protect it from waste. Factors that a court may consider when deciding whether to appoint a receiver are:

    a. The existence of a valid claim by the moving party;

    b. Fraudulent conduct on the part of the defendant;

    c. Imminent danger that property may be lost, concealed, injured, diminished in value or squandered;

    d. An inadequacy of the available legal remedies;

e. The probability that harm to the plaintiff by denial of the appointment is greater than the injury to the parties opposing the appointment;

f. The plaintiff's probable success in the action; and

g. The possibility of irreparable injury to the plaintiff's interest in the property.

h. In addition, courts often consider whether the loan documents provide for the appointment of a receiver as a remedy upon default, although their finding might not necessarily be determinative.

2. An order appointing a receiver often will contain provisions that:

a. Identify the real and personal property of the receivership estate;

b. Recite the procedures and standards relating to reasonable compensation of the receiver;

c. Describe the reports that must be produced and filed by the receiver, including the final report and accounting;

d. Describe the duties, authority, and power of the receiver, which includes (i) the collection of all obligations and money owed the receivership estate, and (ii) the ability of the receiver to preserve and conserve property of the receivership estate, as well as dispose of (whether by sale or through abandonment) and recover (through legal action or otherwise) property of the receivership estate;

e. List the property to be surrendered to the receiver.

3. An order appointing a receiver may also contain a provision that enjoins pending or contemplated litigation, and in this sense, is similar to the bankruptcy automatic stay.

4. An order appointing a receiver may also contain, or direct the receiver to propose, a claims procedure that governs the assertion and payment of creditor claims. The priority of distribution is based upon the laws of the jurisdiction (state or federal) governing the priority of claims.

5. As in a bankruptcy proceeding, the receiver's actions are overseen by the appointing court, and with limited exceptions, the receiver will need to request the court's permission to take any action, and parties in interest are typically provided notice and an opportunity to provide input.

B. Federal Court Receivership: There is no Federal statute governing the appointment of receivers. Rather, the authority for a federal court to appoint a receiver is grounded in common law. There are however several federal statutes governing the actions of federal receivers.

1. It is important to note here that a federal court must have jurisdiction over the matter in order to appoint a receiver. Because a secured creditor's enforcement of its rights is not usually based on a federal question (although federal district courts may appoint receivers in cases initiated by governmental entities for violation of federal laws), diversity and the minimum amount in controversy under title 28 of the U.S. Code § 1332 must exist and is the most common way of obtaining jurisdiction. Therefore, the citizenship of the secured creditor must be different than the citizenship of each and every borrower and guarantor, if applicable, named in the action. If jurisdiction is established, the federal district court then has ancillary jurisdiction to appoint a receiver, as well as ancillary

subject-matter jurisdiction over every suit that the receiver may subsequently initiate.

2. A federal receivership may be most useful when collateral is located in multiple counties or states. Federal receivership actions may be commenced in the federal district of the state in which the property is located or in the state of the borrower's principal place of business, but the court will have jurisdiction over the borrower's property no matter where it is located.

   a. To obtain jurisdiction in property located in other districts, 28 U.S.C. §754 states that within 10 days after entry of the appointment order, a receiver must file a copy of the complaint and the order appointing the receiver in the district for each district in which property is located.

3. Sale of Real Property: 28 U.S.C. §2001 and 2002 govern the sale of real property in a federal receivership. A receiver may use a public or a private sale to sell real property. A public sale must occur in the district in which the receiver was appointed or in some other district, if the court so orders. In addition, the terms and conditions of the sale will be as directed by the court. A notice of a public sale must be approved by the court and published at least once a week for four weeks prior to the sale in at least one newspaper in general circulation in the county, state or judicial district where the property is located. A private sale may occur if the court determines that it is in the best interest of the estate. As with a public sale, the terms and conditions will be as directed by the court. In a private sale, however, the court must appoint three disinterested appraisers to appraise each parcel of property. The originally proposed offer will not be confirmed by the court unless the sales price is two-thirds of the appraised value, or if another

offer of at least 10 percent over the original offer is received. The notice of the private sale must also be approved by the court and published in a newspaper of general circulation at least 10 days prior to the hearing on the confirmation of the sale.

4. Sale of Personal Property: The sale of personal property is governed by the same rules as the sale of real property, unless the court orders otherwise. 28 U.S.C. §2004 gives the district court discretion as to whether appraisals are required to sell personal property.

5. Priorities of Claims: Federal statutes, where applicable, govern claims, liens and priorities in receivership proceedings. Ordinarily, priorities are not governed by state laws, and a state statute of priority must yield to a federal statute. However, while priorities given by state laws are not binding, they are allowed if equitable.

C. <u>State Court Receivership</u>: If there is no federal jurisdiction based on diversity, or there is no concern with receivership estate property in different locations, a state court receivership is an option. Michigan Court Rule 2.622 governs the appointment of receivers in Michigan State Courts.

1. Appointment of a Receiver: Michigan Court Rule 2.622 provides that, when considering a proposed receiver, the court may, but need not, defer to the petitioning party's selection. Even in a case where the appointment is stipulated to or uncontested, the court has the final say. The amendment to MCR 2.622 states that "the court shall appoint the receiver nominated by the party . . . unless the court finds that a different receiver should be appointed."

2. Qualifications of a Receiver: MCR 2.622 requires a receiver to have "sufficient competence, qualifications, and experience to administer the receivership estate." The party seeking appointment of a receiver must describe how the proposed receiver is qualified according to specified factors, including experience in the operation or liquidation of the type of assets to be administered, relevant business, legal and receivership knowledge, and the ability to obtain a bond.

3. Provisions of the Receivership Order: MCR 2.622 provides that six provisions must be included in the receiver order of appointment, plus a catch-all for any other provision "the court deems appropriate." The mandatory provisions include: (1) bonding amounts and requirements; (2) identification of receivership property; (3) procedures related to the receiver's compensation; (4) reports to be produced and filed by the receiver; (5) a description of receiver's duties, authority and powers; and (6) a listing of property to be surrendered to the receiver.

4. Receiver Duties: The rule also sets forth seven receiver duties. The duties include: (1) filing an acceptance of the receivership within seven days of the order of appointment; (2) serving a notice of acceptance of appointment within 28 days after filing the acceptance to all persons having a recorded interest in the receivership estate; (3) filing an inventory of property of the receivership estate within 35 days after entry of the order of appointment; (4) accounting for all receipts, disbursements and distributions of property of the estate; (5) if there are sufficient funds, requesting creditors file proofs of claim; (6) furnishing information concerning the estate to any party after a reasonable request; and (7) filing with court a final written report and a final accounting of the administration of the estate.

5. Receiver Powers: Actions that a receiver may take are identified, and these include: authorization to bring suit, liquidate personal property of the receivership into money, and to pay the ordinary expenses of the receivership, among others. The receiver may not sell real property without a separate order of the court. Additionally, while the receiver may pay expenses of the estate, it may not distribute funds of the estate to a party without an order of the court.

6. Priorities of Claims: The statute does not set forth claim priorities, rather whether certain claims are paid before others is based, as mentioned above, on state common and statutory law. For example certain employee wages and benefits are entitled to priority over other types of unsecured claims.

7. Commercial Real Estate: Michigan recently adopted the Uniform Commercial Real Estate Act. Prior to the Act, Michigan statutes provided for the appointment of a receiver of real estate in a limited number of circumstances – waste and unpaid real property taxes. Under the Act, several grounds for receiver appointment were added. They include: written agreement by mortgagor to receiver appointment on default, the property securing the mortgage is insufficient to satisfy the mortgage debt, the mortgagor fails to turn over rents the mortgagee is entitled to collect.

    a. Sale of Real Property: Although Michigan courts have entered orders facilitating receiver sales of real property free of redemption rights and liens prior to the Act, the authority for those orders were never clear.

    b. Sale Free of Redemption Rights**.** Prior to the Act, Michigan law did not permit receiver sales free of the real property owner's statutory right of redemption under the foreclosure

statutes. The Act however, provides that commercial real estate may be sold by a court appointed receiver in the ordinary course of business without a court order, or, outside the ordinary course of business with a court order – and, in either event, there is no right of redemption for the property owner. Thus, the receivership sale purchaser does not have to await the expiration of a redemption period to take possession of the property. This result is unlike the typical advertised or judicial foreclosure sale, both of which mandate a right of redemption.

c. Sale Free and Clear of Liens. The Act also allows for real property to pass to the purchaser free and clear of the liens of the creditor who obtained the appointment of the receiver, as well as all junior liens, although the property remains subject to any senior liens. The lien of the creditor who obtained the receiver and any junior liens attach to the sale proceeds of sale of the receivership property in the same validity, perfection and priority as immediately before the sale.

IV. ASSIGNMENT FOR THE BENEFIT OF CREDITORS:

An alternative to the state court receivership is an Assignment for the Benefit of Creditors ("ABC"). The primary difference is that an ABC is debtor driven rather than creditor driven. It is the debtor that decides to assign its property to an assignor of its choosing, who then liquidates those assets to pay the debtor's creditors.

A. An ABC is a Michigan statutory remedy (Michigan Compiled Laws 600.5201) in which the debtor voluntarily executes an assignment turning over its assets to a friendly assignor. A case is opened with the court in

which the court will typically approve the Assignee. A list of the debtor's creditors must be filed with the court along with the assignment document.

B. The Assignor must post a bond, and once that is done and approved, the assignee is granted immediate control of all of the debtor's non-exempt assets.

C. The Assignee is considered the trustee of the estate of the debtor for the benefit of its creditors and may recover all property or rights or equities in property which might be recovered by any creditor.

D. The statute requires the Assignee to provide notice of the assignment to all of the debtor's creditors advising them of the assignment and requiring them to file proofs of claims.

E. Although not explicitly provided for in the statute provided for in the statute, the Assignee may request that the court enjoin creditor lawsuits or other collection activity.

F. The statute also sets forth the order in which claims must be paid. Funds available for distribution are to be paid in the following order:

1. All taxes legally due and owing by the assignor to the United States, state, county or municipality;

2. The cost of administration;

3. All labor debts entitled to preference under the laws of this state;

4. All other debts which under the laws of the United States or of this state are entitled to priority;

5. All other claims preferred and allowed;

6. Any remaining surplus to be paid to the assignor, his representatives or assigns.

If funds are insufficient to pay any class in full, then the same shall be distributed pro rata amongst the creditors of the class.

G. The statute sets forth the powers of the Assignee, which includes the ability to:

1. Sue to recover property of the debtor's estate, and to enforce any causes of action the debtor may have possessed.

2. Take possession of all of the property of the debtor's estate, including all books, vouchers and papers relating to the same.

3. Sell the assets at public auction or at private sale, as provided in the statute.

4. Settle all matters and accounts between such assignor and his debtors and creditors and examine, on oath to be administered by him, any person touching such matters and accounts;

5. Prosecute or defend suits pending in favor of or against the debtor.

H. From the creditor's perspective, the ABC has the benefit of court oversight, a third party fiduciary (the Assignee), and a well-defined set of rules and procedures, maybe even more so than a state court receivership. It is advantageous from the debtor's perspective as well in that the debtor is the one who elects the forum and the third party fiduciary. In this respect, as compared to a Chapter 7 liquidation, the third party may be less likely to look into the debtor's affairs and proceed with causes of action against its principals.

V. VOLUNTARY SURRENDER AND ARTICLE 9 SALES:

In cases where the debtor is concerned with lenders who have security interests in personal property (as opposed to real estate), one option may be to surrender the property to the lender and allow the lender to conduct a sale of the property.

Uniform Commercial Code 9-610(a) provides that "[a]fter default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." Article 9 thus offers broad flexibility to the secured lender in the disposition of its collateral. The secured lender's guiding principle, however, is that "every aspect" of a sale, "including the method, manner, time, place, and other terms, must be commercially reasonable."

A. Although Article 9 of the Uniform Commercial Code gives the lender the right to repossess and sell the property, what we are talking about is having the debtor agree to voluntarily surrender the property pursuant to a surrender agreement, and allowing the lender to proceed with the sale.

B. Public or Private Sale: Once the property is turned over to the lender, the lender must determine whether to dispose of the collateral in a public or private sale. The determination depends on the circumstances. If the secured lender wants to purchase the collateral for itself, a public sale is generally required. A secured lender cannot purchase collateral in a private sale unless the collateral is "of a kind customarily sold on a recognized market" or "the subject of widely distributed standard price quotations." A public sale requires that the public have access to the sale and the sale be advertised. Proper advertisement calls for commercially reasonable notice of the time, place, and terms of the sale as well as notice of the collateral to be sold. In many cases, a private sale is preferable. A private sale does not require any marketing because the public does not participate in the sale process. As such, a buyer in a private sale does not risk being outbid, and the financial condition of the company being sold is not publicized.

C. Regardless of the type of sale, the secured lender must give notice to certain interested parties of its intention to sell the collateral. The

interested parties are the debtor, any secondary obligor on the debt, and any other creditors who are secured in the property.

D. Commercial Reasonableness: In addition to the notice requirements, Article 9 imposes the standard of commercial reasonableness on "every aspect" of the sale "including the method, manner, time, place, and other terms." The meaning of this provisions is not entirely clear, and the Uniform Commercial Code does not provide helpful parameters. It is apparent, however, that even though the foreclosing lender is not required to get the best possible price for the collateral, taking steps to maximize recovery will help to ensure the sale is commercially reasonable.

E. Purchaser Takes the Property Free and Clear: The purchaser of the property will take whatever rights the debtor had in the property. The lender’s security interest is discharged as well as any subordinate security interests and liens. Security interests senior to the lender’s interest remain.

F. Applying Sale Proceeds: Article 9 prescribes the order in which the proceeds of a sale should be applied. First, proceeds must pay expenses in connection with the sale including, to the extent provided for in the security agreement, attorneys' fees and legal expenses. Second, proceeds must be applied to satisfy the outstanding debt owed to the lender. Third, proceeds must be applied to satisfy any debts secured by security interests junior to the foreclosing lender's security interest. Any surplus must be remitted to the debtor. If the proceeds are insufficient to satisfy the lender's debt after paying expenses, the secured lender may pursue a claim against the debtor to collect the deficiency.

D. As mentioned earlier, a drawback of Article 9 sales is that the process is not ideal if real estate is involved. In such a case, the lender would not have an ability to sell the assets as a single package because Article 9

does not apply to real estate transactions. In addition, the lender must comply with the requirements of Article 9, and the failure to do so may result in the sale being restrained, or liability for the lender. In many cases, the lender would rather a court oversee and bless any sale at the outset.

VI. <u>TRUST MORTGAGES</u>:

A Trust Mortgage is similar to an Assignment for the Benefit of Creditors, however there is no court proceeding or oversight. It involves the debtor executing an agreement to turn over its assets to a Trustee of its choosing, granting the Trustee a security interest in the assets, and allowing the Trustee to liquidate the assets and distribute the proceeds to creditors, according to a priority scheme agreed to and set forth in the agreement, but which generally follows the priority scheme under the Bankruptcy Code.

A. The possible advantage of the Trust Mortgage over the Assignment for the Benefit of Creditors is that there is no court oversight. This may be important for certain debtors who do not want public record of their insolvency proceedings. But this can be a disadvantage as well. Creditors may be less likely to cooperate in a Trust Mortgage without the oversight and blessing of a court, and perhaps less of an assurance that the Trustee is acting in the best interests of the creditors.

B. In addition, unlike an assignment for the benefit of creditors, the Trust Mortgage does not enjoin actions by the creditors, and so there remains a possibility that a disgruntled creditor decides to take action and try to enforce its creditor remedies. The idea with the Trust Mortgage however, is that creditors will have some comfort in the fact that the Trustee is supposed to be acting in the best interests of all of the debtor's creditors and that assets will be distributed properly. Ideally this would allow the creditor a sufficient amount of confidence that it will be treated fairly.

VII. FIDUCIARY ALTERNATIVES.

Another alternative to the mechanisms we have discussed is the debtor's appointment of an outside chief restructuring officer, or the retention of financial advisors. The idea here is that these professionals would be selected with the primary creditor(s) input, or even selected by the creditor(s). Although this alternative does not provide the protections of some of the foregoing remedies, like an automatic stay, or injunction of creditor actions, the presence of financial professionals or a chief restructuring officer will give the debtor some credibility that appropriate measures are being taken to address its finances and creditor concerns.

VIII. RETAINING CONTROL AND LIQUIDATING.

Finally, one more option is to simply retain control of the business and liquidate the assets and use whatever proceeds are available to pay creditors. Out of all of the alternatives discussed herein, this is the least expensive and does not involve court oversight. It does however provide the most risk, because nothing enjoins creditors from taking action against the debtor. Nor is there a fiduciary or other third party in place that provide piece of mind to creditors. Practically speaking, this course of action will only work in a situation where creditors are somewhat less aggressive, for one reason or another.

IX. PRACTICE CONSIDERATIONS.

Deciding which of the above approaches to utilize when dealing with creditors really depends on the specific circumstances of the debtor. The size of the business, the number of creditors and their aggressiveness, the size of the overall debt load, the debtor's ability to fund a reorganization (which is often tied to the debtor's ability to obtain further financing) or liquidation process, and the debtor's desires, including whether to remain out of court, or whether to try to continue operating at all.

A. Regardless of what the debtor would like to do, it will have more options the earlier it seeks to address its creditor problems. You can help your client by recognizing the signs of impending insolvency and suggesting action. Some signs are as follows:

1. Judgments entered against the debtor, or lawsuits filed by its creditors.

2. The presence of unpaid state or federal withholding taxes.

3. The debtor is in a workout or forbearance agreement with a lender.

4. Major pending litigation.

5. The insistence of trade creditors on C.O.D. or C.I.A. terms.

B. With respect to the work you may be doing for the debtor/client, the out of court options discussed provide more of an opportunity to remain involved with the process and continue to assist the client. In addition, you should have the client provide a retainer as an advance payment to cover final tax returns and other incidentals. Once the company has been turned over to a fiduciary, it may be difficult to have these expenses paid, particularly when a lender is involved.

C. One other thing to keep in mind when counseling the client/debtor is that when insolvency looms, the status quo should be maintained. There may be a desire to transfer ownership of assets to a non-debtor third party. That should be avoided, as fraudulent transfer laws will allow a creditor or fiduciary (a bankruptcy trustee or receiver) to claw back those transfers, and will lead to liability of the transferees. In addition, the presence of such transfers will only encourage creditors or fiduciaries to dig deeper into the debtor’s affairs in search of additional sources of recovery.